

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLANT**

77-5036 ^{1/27}
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To be argued by
Solomon M. Cheser

United States Court of Appeals

FOR THE SECOND CIRCUIT

IN RE EASTERN FREIGHT WAYS, INC.,

**SIDNEY B. GLUCK, Trustee in Bankruptcy of EASTERN FREIGHT
WAYS, INC.,**

Plaintiff-Appellee,

against

SEABOARD SURETY COMPANY,

Defendant-Appellant,

**MANUFACTURERS HANOVER TRUST COMPANY, individually and
as agent for other institutional lenders, INTERNATIONAL HARVES-
TER CREDIT CORPORATION, FRUEHAUF CORPORATION
and THE CHASE MANHATTAN BANK, NATIONAL ASSOCIA-
TION, and THOMAS J. CANNILL, Trustee in Bankruptcy of ASSO-
CIATED TRANSPORT, INC.,**

Defendants-Appellees.

**On Appeal from the United States District Court for the
Southern District of New York**

**BRIEF OF DEFENDANT-APPELLANT
SEABOARD SURETY COMPANY**

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BRIEF OF DEFENDANT-APPELLANT SEABOARD SURETY COMPANY

Preliminary Statement

This brief is submitted on behalf of the Appellant, Sea-
board Surety Company ("Seaboard"), a defendant below,

in support of its appeal to this Court from the order of United States District Judge Edmund L. Palmieri, dated October 31, 1977, which affirmed the order of Bankruptcy Judge Roy Babitt entered on May 27, 1977.

Issues Presented for Review

1. Whether, under this Court's decision in *In re Yale Express System, Inc.*, 362 F.2d 111 (1966) ("*Yale Express*"), Seaboard has the right to the benefit of setoffs of amounts owing under bonds against accounts receivable, unaffected by the existence of the proceeds of the letter of credit in Seaboard's hands as independent security.

2. Whether the injunction issued below against Seaboard was an improper impairment of the surety's rights, recognized in *Yale Express*, to notify Eastern's shipper-customers of their right of setoff.

3. Where the proceeds of the letter of credit are held by an adverse claimant with a substantial and bona fide claim to them, whether the premising of summary jurisdiction in the bankruptcy court to adjudicate the use and application of such proceeds, as "a necessary prerequisite to the final resolution of the rights of the parties" with respect to unrelated issues involving setoffs and accounts receivable, is an improper expansion of the limited summary jurisdiction granted the bankruptcy court by the Bankruptcy Act.

Statement of the Case

The Facts

The facts of the case can be stated briefly by paraphrasing the district court's description (R 663a-666a).^{*} Eastern Freight Ways, Inc. ("Eastern") and Associated Transport, Inc. ("Associated") were licensed common carriers of freight under the regulatory authority of the Interstate Commerce Commission. In accordance with the Commission's regulations, Eastern and Associated were authorized to act as self-insurers against various casualties, including cargo losses sustained by their shipping customers. Eastern gained control of Associated in 1974 and, upon authorization of the ICC, was thereafter operating and managing Associated's affairs.

Prior to 1974 and prior to the control of Associated by Eastern, Seaboard had issued various types of bonds in connection with Associated's liability as self-insurer to third parties arising out of the operation of its shipping business. Seaboard had required and received from Associated over \$600,000 in collateral to secure its position on its outstanding bonds issued at Associated's request (Wehrell affidavit, para. 4; R 354a). At that time Seaboard had issued no bonds in connection with Eastern's liability as a self-insurer.

After Eastern gained control of Associated, Eastern requested that Seaboard act as surety for Eastern as well as Associated. Seaboard's agreement thereto was achieved with the execution in September, 1974, of a number of agreements among Seaboard, Eastern and Associated. These included:

^{*} The Record on Appeal, reproduced in its entirety in the Joint Appendix, is cited as ("R—a").

(1) A "Collateral Agreement" under which Eastern and Associated agreed to provide collateral for Seaboard's exposure under any bonds issued or to be issued by it on behalf of Eastern and/or Associated (R 359a-362a);

(2) A "General Agreement of Indemnity" under which Eastern and Associated agreed to indemnify and hold Seaboard harmless against liabilities incurred by Seaboard under such bonds (R 363a-367a).

To collateralize Seaboard on such combined suretyship program, it was agreed that Seaboard would be afforded a \$2,000,000 letter of credit from the Chase Manhattan Bank, N.A. ("Chase"). Upon the execution of the aforesaid agreements and letter of credit, Seaboard issued its surety bonds to both Eastern and Associated. At the same time it released the Associated collateral of more than \$600,000 which Seaboard then held (Wehrell Affidavit, para. 6; R 355a-356a).

The \$2,000,000 letter of credit was issued by Chase on September 12, 1974. The aforesaid Collateral Agreement provided, in part, that the letter of credit would be furnished to Seaboard to secure it on bonds written for:

"Eastern Freight Ways, Inc. and/or Associated Transport, Inc. and/or any its' [sic] or their divisions, and/or any subsidiary corporation, corporations or interests now existing or hereinafter created or acquired, or any of them or any combination of them . . ." (R 359a).

A copy of the Collateral Agreement is annexed as Exhibit A to the Wehrell affidavit (R 359a-362a).

The aforementioned letter of credit authorized Seaboard to draw down the \$2,000,000 upon written certification that it had not been released from liability under the surety bond(s) or undertaking(s) executed on behalf of Eastern

and that Seaboard would refund to Chase any unexpended portion of the proceeds (R 269a-270a).

Subsequent to the above arrangements, Eastern conveyed security interests in its accounts receivable to Manufacturers Hanover Trust Company ("Manufacturers"), International Harvester Credit Corporation ("International Harvester"), and Fruehauf Corporation ("Fruehauf").

Eastern and Associated filed petitions for arrangement under Chapter XI of the Bankruptcy Act on April 22, 1976, and both were adjudged bankrupt on April 28, 1976. (Eastern briefly re-entered Chapter XI in June of 1976, but was again adjudged bankrupt on August 25, 1976.) Sidney B. Gluck, plaintiff below, was appointed trustee in bankruptcy of Eastern ("Eastern trustee"), and Thomas J. Cahill was appointed trustee in bankruptcy of Associated ("Associated trustee").

When these Chapter XI petitions were filed, Eastern and Associated had between them approximately 20,000 unpaid cargo claims which were then presented to Seaboard. Many of these were asserted by claimants who also owed freight charges to Eastern. On April 28, 1976, when Eastern and Associated were originally adjudged bankrupt, Seaboard delivered its certification to Chase, took down the proceeds of the letter of credit, and began to use such proceeds to satisfy claims on the bonds which it had written for Eastern and Associated. Seaboard also sent letters to the shipping customers of Eastern and Associated, advising them of their right to set off sums they owed for freight charges against their cargo claims and stating that Seaboard would be responsible for no more than the difference between the two (R 271a).

The present proceeding was commenced on November 3, 1976, by the filing of the Eastern trustee's complaint which pleaded three causes of action. The first sought, *inter alia*, a determination that because of the assignments of the

accounts receivable, Seaboard could not advise Eastern's customers to set off their cargo claims against Eastern's freight charges. The second sought damages for Seaboard's alleged conversion of Eastern's accounts receivable. (This cause was dismissed by the bankruptcy court and was not the subject of any appeal or cross-appeal.) The third cause of action (which repeated and realleged the entire first cause of action) set forth two additional requests for relief: first, a declaration that the proceeds of the letter of credit may be used by Seaboard to satisfy only claims under bonds written specifically in the name of Eastern, and second, a judgment that Seaboard must first exhaust the proceeds of the letter of credit before being permitted the benefit of setoffs.

All defendants except Seaboard answered, most of them asserting crossclaims against Seaboard. Seaboard moved to dismiss the first and second causes of action and related crossclaims for failure to state claims upon which relief could be granted; it moved to dismiss the third cause of action and related crossclaims on the ground that the bankruptcy court lacked jurisdiction to grant the relief requested.

The bankruptcy court rendered an opinion (R 531a-542a) on April 7, 1977, which in essence denied Seaboard's various motions to dismiss (except as to the second cause of action), awarded declaratory relief to the Eastern trustee to the effect that no setoff can be claimed by Seaboard until the proceeds of the letter of credit are exhausted, made permanent a temporary injunction restraining Seaboard from sending letters to Eastern's customers, and set down an evidentiary hearing on the proper allocation of the proceeds of the letter of credit. The latter hearing was stayed pending the resolution of an appeal by any aggrieved party. An order was entered on May 27, 1977, in accordance with that opinion (R 543a-549a). Seaboard's appeal to the district court followed.

The Decision of the District Court

The district court affirmed the order of the bankruptcy court and held that:

1. The Eastern trustee was entitled to declaratory relief to the effect that no setoff can be claimed by Seaboard until the proceeds of the letter of credit were exhausted. It therefore affirmed the making permanent a temporary injunction restraining Seaboard from sending letters regarding setoffs to Eastern customers (R 668a-669a).

2. The bankruptcy court did not have actual or constructive possession of the proceeds of the letter of credit upon which to base its summary jurisdiction with respect to their proper use and application. Rather, as an adverse claimant, Seaboard had possession of, and a substantial and bona fide claim to, such proceeds (R 670a). Similarly, summary jurisdiction over application of the proceeds could not be predicated upon express or implied consent by Seaboard to such jurisdiction (R 671a-672a).

3. The bankruptcy court has summary jurisdiction to determine the application of the proceeds because such a determination is a necessary prerequisite to the final resolution of the rights of the parties with respect to setoffs, a question within the bankruptcy court's jurisdiction (R 672a-673a). But whether the bankruptcy court has summary jurisdiction to compel any particular use of the physical proceeds is a question which must abide the further course of the litigation (R 673a-674a).

ARGUMENT**POINT I**

***In re Yale Express System, Inc.*, 362 F.2d 111 (2d Cir. 1966), controls the instant controversy.**

In arriving at its decision, the district court correctly noted:

"All of the parties are in agreement that the analysis must commence with the landmark case of *In re Yale Express System, Inc.*, 362 F.2d 111 (2d Cir. 1966) ("Yale Express"), and that the essential question posed here is whether that authority is controlling on these facts." (R 667a).

Accordingly, we will start with an analysis of the *Yale Express* holding as applied to the facts of the instant case.

In *Yale Express*, as here, a surety in meeting its bond obligations to shippers sought the benefit of setoffs between the freight charges due from shippers to a carrier and the cargo claims had by such shippers against the carrier.

The district court correctly noted that in such circumstance:

"In *Yale Express*, a Chapter X case, the United States Court of Appeals for the Second Circuit held that 'the surety of an insolvent debtor is entitled to have a creditor apply a debt owing to the debtor to satisfaction of his claim', *supra*, at 116." (R 667a).

In *Yale Express*, as here, the surety had notified some of the shippers who had made cargo claims against it of their right to set off such claims against freight charges due the carrier.

While in the instant case the district court has permanently enjoined Seaboard from so notifying shippers, in *Yale Express* the Court of Appeals upheld the right of the surety to give such notice. Indeed it would have required:

"... the trustee to require the shippers to apply their security, to wit, their indebtedness for freight, for Boston's (Seaboard's) benefit in the only way in which this particular form of security can be applied, by reducing the claims against both principal and surety." 362 F.2d at 115, parenthesis added.

While here the district court paralleled *Yale Express* when it confirmed

"... the equitable right of bankrupt debtors and their creditors (such as Eastern and its shipping customers) to set off mutual debts . . ." (Court's parenthesis),

it departed from *Yale Express* when it denied:

"... the alleged right of the bankrupt's surety to solicit and take advantage of such setoffs." (R 667a).

How then did the court below justify its departure from the *Yale Express* holding that "the surety of an insolvent debtor is entitled to have a creditor apply a debt owing to the debtor to satisfaction of his claim"?

Its first step to its conclusion that the instant case was not governed by *Yale Express* was to characterize the holding in *Yale Express* as "an exception to the general rule that a surety cannot compel a solvent principal to assert a counterclaim against third party creditors nor use the principal's counterclaim when sued by such creditors." (R 667a).

We respectfully submit that the rule affirmed in *Yale Express* for dealing with an insolvent principal cannot

accurately be stated to be an exception to a rule established in cases dealing with *solvent principals*. We respectfully suggest that the very case cited by the district court for what it termed the "general rule" did indeed set forth an exception to the "general rule" dealing with solvent principals.

The case so cited by the district court is *Meeker v. Halsey*, 87 F.2d 299 (2d Cir. 1937), and the district court called attention to the fact that the *Meeker* case had been cited in *United States ex rel. Johnson v. Morley Const. Co.*, 98 F.2d 781, 789 (2d Cir. 1938).

We deem it important to point out that the *Meeker* court gave a reason for the "general rule," that reason being that "the principal may prefer to reserve his claim against the creditor for prosecution on another occasion." 87 F.2d at 301.

The New York State Court of Appeals summarized the reasons underlying the so called "general rule" in *Walcutt v. Clevite Corp.*, 13 N.Y.2d 48, 241 N.Y.S.2d 834, 191 N.E.2d 894 (1963):

"The situation is readily distinguishable from cases in which the rule was fashioned that a guarantor when sued alone by the creditor cannot avail himself of an independent cause of action existing in favor of his principal as a defense or counterclaim (*Ettlinger v. National Sur. Co.*, 221 N.Y. 467; *Gillespie v. Torrance*, 25 N.Y. 306; *Lasher v. Williamson*, 55 N.Y. 619; *Elliott v. Brady*, 192 N.Y. 221). The reasons underlying this rule are extensively discussed in both the *Ettlinger* and *Gillespie* cases (*supra*), and may be summarized by the proposition that a guarantor may not take upon himself the election of remedies which rightfully belongs solely to his principal. Thus, a guarantor may not inter-

pose his principal's defense of fraud since by so doing he would deprive the principal of his independent right to affirm or disaffirm (*Ettlinger v. National Sur. Co.*, *supra*.) Likewise, he may not assert his principal's claim of breach of warranty since 'he might thus bar a large claim in canceling a small one' (*Gillespie v. Torrance*, *supra*, p. 311). In all of these instances the claim is deemed to be an independent cause of action existing in favor of the principal, which he alone may or may not assert in what he deems to be his best interest." 13 N.Y. 2d at 55-56.

We respectfully suggest that where the reasons for the so called "general rule" do not exist, there would then be an exception to the "general rule" dealing with a solvent principal.

Indeed, in *Meeker*, the court specifically noted such an exception when it wrote, *supra*, 301:

"If however the principal (albeit solvent) has shown that he means to set off the claim, no injustice is done the creditor if the surety does the same." (our parenthetical inclusion)

Accordingly, we respectfully suggest that the holding in *Yale Express*, that "the surety of an insolvent debtor is entitled to have a creditor apply a debt owing to the debtor to satisfaction of his claim" (362 F.2d at 116), is not an exception to the "general rule" referred to by the district court.

Indeed, we urge that there are two general rules standing side by side:

1. Where the principal is solvent and has not "shown that he means to set off the claim," and

2. Where the principal is insolvent or, albeit solvent, "has shown that he means to set off the claim."

The courts below after, we suggest, wrongfully concluding that the principle articulated in *Yale Express* was an exception to the "general rule," then assigned a reason for such exception. The district court quoted the bankruptcy court with approval:

"[t]he exception is bottomed on the fact that without the right of set off, the surety would have no recourse against the insolvent principal and as a result the estate of the principal becomes enriched at the surety's expense." (R 667a).

We respectfully suggest that the court below erred when it treated the *Yale Express* holding as having been "bottomed" on the foregoing observation. True it is that Judge Friendly, in the course of his opinion for the Court in *Yale Express, supra*, at 115, quoted at some length from Judge L. Hand's opinion in *Morley, supra*. We suggest that the chief reason Judge Friendly did so was to justify departure from "the rule conditioning subrogation on full payment by the surety" (*supra*, 115 n.3). We suggest again that pertinent is that portion of Judge Hand's decision which stated:

"However, it is only after the surety pays the creditor that he is subrogated to all the creditor's securities, and that would be a condition here, except that the surety cannot pay the debt without losing the security, for it consists only of the creditor's power to defeat the counterclaim by using his claim to cancel it. Therefore to exact of the surety the normal condition of paying the debt, would be to destroy the security, and it follows that he must be allowed to set it up himself."

Apart from the fact that the quoted portion from *Morley* is but dicta and not essential to that court's decision, we deem it significant that the *Morley* opinion nowhere sets forth circumstances where the surety of an insolvent debtor would not be entitled to have a creditor apply a debt owing to the debtor to satisfaction of his claim. Indeed, in the many briefs opposing Seaboard submitted below, not one case was cited in which a surety of an insolvent debtor was denied the right to be subrogated to a creditor's right of setoff.

At the outset of the opinion in *Yale Express*, Judge Friendly formulated for this Court the requirements to grant the Boston Insurance Company (here, Seaboard) the relief it sought:

"In order to succeed on appeal Boston must establish:

"(1) That it stood as a surety for Yale with respect to the claims here in question;

(2) That as a surety it was equitably entitled to require a deduction of freight owing to Yale;

(3) That this equitable right should be recognized in bankruptcy; and

(4) That enforcement of the right would not unduly interfere with the rehabilitative objective of the Chapter X proceeding." 362 F.2d at 114.

It is significant that Judge Friendly did not list a fifth requirement to the effect that Boston have no recourse against Yale's trustee.

Nothing in *Yale Express* suggests that had Boston, with the foresight of Seaboard, obtained such security from Yale it would have lost its right to be subrogated to a shipper's acknowledged right to set off cargo claims against

the freight bill it owed the bankrupt. Accordingly, *Yale Express* should have guided the courts below to an opposite decision.

In *Yale Express* the Court of Appeals unequivocally gave the surety the benefit of such setoffs because:

"We see no inconsistency in applying in bankruptcy the equitable principle that the surety of an insolvent debtor is entitled to have a creditor apply a debt owing to the debtor to satisfaction of his claim, which the creditor would do as a matter of course but for his right to pursue the surety." 362 F.2d at 116.

Again, there is in *Yale Express* nothing to suggest that such right of the surety of an insolvent debtor is in any way destroyed or delayed because the surety had the foresight to insist on the security of a letter of credit before it would issue its bonds.

The courts below recognized that the existence of proceeds of a letter of credit would not prohibit the shipper, itself, from offsetting against Eastern's freight bill a cargo claim it had against Eastern (R 667a). That right is given to the shipper not by judicial fiat but by Bankruptcy Act 68a (11 U.S.C.A. §108a) and was so recognized in *Yale Express*. What the courts below have impaired is the surety's well-settled right of subrogation.

Judge Friendly took cognizance of this factor of subrogation where a principal was insolvent when he wrote at 362 F.2d 114:

"It is equally well settled that 'where the duty of the principal to the creditor is fully satisfied, the surety to the extent that he has contributed to this satisfaction is subrogated * * * to the interests which the creditor has in security for the principal's

performance and in which the creditor has no continuing interest.' Restatement, Security § 141. The claimants' power to satisfy their damage claims in whole or in part by deducting their liability for unpaid freight was security of the most perfect kind."

The decision then noted that the surety remained

"... liable to the creditor only for the amount not covered by the principal's claim against him. *Scholze v. Steiner*, 100 Ala. 148, 14 So. 552 (1893); *Armstrong v. Warner*, 49 Ohio St. 376, 31 N.E. 877, 17 L.R.A. 466 (1892); *St. Croix Timber Co. v. Joseph*, 142 Wis. 55, 124 N.W. 1049 (1910)."

The principle thus stated by Judge Friendly finds statutory support in 11 U.S.C.A. § 93(i) (§ 57i of the Bankruptcy Act). It is there provided that one in the position of a surety "shall be subrogated to the rights of the creditor." Such principle was long ago recognized in *In re Thompson*, 288 F. 385, 389 (W.D. Pa. 1923), *aff'd*, 294 F. 247 (3d Cir. 1923):

"Had the Bankruptcy Act (Comp. St. §§ 9585-9656) been silent on the subject, the rights of a paying surety in a court of equity would have been fully recognized. At common law, when a surety pays to a creditor what the principal owed, he is entitled, unless he has waived his right, to be subrogated to all the rights possessed by the creditor in respect of the debt. Cases without number could be cited, sustaining the right of subrogation. The principle is well stated by Chief Justice Marshall, in *Lidderdale v. Robinson*, Fed. Cas. No. 8,337, as follows:

"The principle which the cases decide is this: Where a person had paid money for which others

were responsible, the equitable claim which such payment gives him, or those who were so responsible, shall be clothed with the legal garb with which the contract he has discharged was invested, and he shall be substituted, to every intent and purpose, in the place of the creditor whose claim he has discharged. This principle of substitution is completely established in the books, and, being established, it must apply to all persons who are parties to the security, so far as is equitable. The cases suppose the surety to stand in the place of the creditor, as completely as if the instrument had been transferred to him, or to a trustee for his use.'

"On this proposition there is no divergence of opinion, the cases being in complete harmony. The right of subrogation, it has been frequently held, applies as well when payment has been made in part as where the entire debt has been paid. But the Bankruptcy Act was not silent on this important matter. Section 57i of that act provides:

'Whenever a creditor, whose claim against a bankrupt estate is secured by the individual undertaking of any person, fails to prove such claim, such person may do so in the creditor's name, and if he discharge such undertaking in whole or in part he shall be subrogated to that extent to the rights of the creditor.'

Section 57i of the Bankruptcy Act was again invoked in *Allen v. See*, 196 F.2d 608 (10th Cir. 1952), in the course of that court's recognition of the surety's right of subrogation:

"It is well settled that where one secondarily liable is called upon to make good on his obligation and

pays the debt, he steps into the shoes of the former creditor. He becomes subrogated to all the rights of the creditor against the principal debtor, including the security given to secure the debt. In fact, Section 57 sub. i . . . provides among others that where one secondarily liable discharges his obligation by payment of the principal debtor's obligation, he becomes subrogated to the rights of the creditor." 196 F.2d at 610.

We suggest that the issues revolving about Seaboard's right to the benefit of setoffs involve the question of just what does Seaboard owe to a shipper who has a cargo claim against Eastern and a debt due to Eastern for its freight charges. *Yale Express* has given its answer to this question:

"But when the principal is insolvent, the surety may set off the principal's claim, *Clark Car Co. v. Clark*, 48 F.2d 169 (3 Cir. 1931); Restatement Security §133 (2) (c), or obtain a decree requiring the creditor and the principal to adjust their controversies, remaining liable to the creditor only for the amount not covered by the principal's claim against him. *Scholze v. Steiner*, 100 Ala. 148, 14 So. 552 (1893); *Armsrong v. Warner*, 49 Ohio St. 376, 31 N.E. 877, 17 L.R.A. 466 (1892); *St. Croix Timber Co. v. Joseph*, 142 Wis. 55, 124 N.W. 1049 (1910)." 362 F.2d at 114-15.

Judge Friendly's opinion in this regard reflects that in *Prudential Insurance Co. of America v. Nelson*, 101 F.2d 441, 443 (6th Cir. 1939), *cert. den.*, 308 U.S. 583 (1939):

"The principle upon which the Rule [§ 68a] proceeds is that in case of mutual debts, it is only the

balance which is the real and just sum owing by or to the bankrupt.”*

POINT II

Other equitable considerations supporting reversal of the court below.

A. To sustain the court below would impair Seaboard's right to negotiate security for its bond obligations.

If at the time Seaboard had written its bonds for the combined Eastern and Associated program, it had not requested a letter of credit as additional security, it is clear from the opinion below that in the event of the bankruptcy of Eastern and/or Associated, Seaboard would have been entitled to the benefit of the setoffs it here seeks. Both courts below have held that the only impediment to Seaboard's immediate benefit of setoffs and the right to notify shippers of their Section 68a right to setoffs was the existence of the proceeds of the letter of credit.

Seaboard, however, did require collateral security in addition to the right of setoff provided it by law as affirmed in *Yale Express*. Seaboard required that additional security to be a \$2,000,000 letter of credit. To meet that requirement, without which it can be presumed the bonds would not have been issued, such letter of credit was furnished to Seaboard.

We respectfully suggest that the holding below has, in effect, abrogated the contract between the parties. The

* This principle strongly suggests that when Eastern assigned accounts receivable, all that was assigned was “the real and just sum of money owing . . . to” Eastern, *i.e.*, the freight bill less the cargo claim.

holding below has the effect of stating: "Seaboard, if you wish a letter of credit as collateral security for the obligations you undertake by the issuance of your bonds in addition to the right of setoff, you cannot have it, because if you insist on the collateral, you must forego the right of setoff."

We respectfully suggest that the court should not be permitted to deprive a surety of its right to have not only the benefit of setoffs, but also the availability of the proceeds of a letter of credit. Particularly is this so here where no one has controverted the statement of Walter S. Wehrell at paragraph 12 of his affidavit (R 358a) to the effect that "... Seaboard's liabilities on the bonds and undertakings will far exceed the \$2,000,000 we realized from the letter of credit."

B. Disposition of the proceeds of the letter of credit will have no effect on the administration of Eastern's estate.

Seaboard and the defendant Associated contend that the proceeds of the letter of credit constitute security for the payments made, and to be made, by Seaboard on bonds issued on behalf of:

"Eastern Freight Ways, Inc. and/or Associated Transport, Inc. and/or any of its' [sic] or their divisions, and/or any subsidiary corporation, corporations or interests now existing or hereinafter created or acquired, or any of them or any combination of them,"

as provided by the Collateral and Indemnity Agreements attached to the affidavit of Walter S. Wehrell (R 359a-367a).

Chase, Manufacturers, International Harvester and the Eastern trustee contend that such proceeds constitute security only for payments made on bonds issued by Seaboard actually bearing Eastern's name, excluding other bonds issued on behalf of Eastern.

It is respectfully submitted that the ultimate resolution of these conflicting contentions will have no financial effect on the trustee or on the bankrupt's estate.

Because of Eastern's agreement to indemnify Seaboard for its payments on the bonds issued for Eastern, Associated and others, the total of the claims filed jointly by Chase and Seaboard against the Eastern estate will be in the same amount regardless of how Seaboard has applied the proceeds of the letter of credit.

To the extent that Seaboard has made payments of claims out of such proceeds and thus does not have them available for refund to Chase, Seaboard's claim against the bankrupt's estate for reimbursement will be reduced and the claim against it of Chase will be correspondingly increased.

To the extent that Seaboard has not applied the proceeds of the letter of credit to payment of claims and will thus be compelled to pay over any such unexpended proceeds to Chase, Seaboard's claim against the bankrupt's estate will have been increased and that of Chase correspondingly reduced.

Accordingly, as the bankruptcy court noted at page 30 of the transcript of the December 13, 1976 hearing: "Either way we just have one claimant or the other" (R 431a).

It follows that the controversy relative to the application of the proceeds of the letter of credit is one "solely

and exclusively between third parties," one over which a bankruptcy court lacks jurisdiction.* *First State Bank and Trust Company of Guthrie, Oklahoma v. Sand Springs State Bank*, 528 F.2d 350 at 353 (10th Cir. 1976). As stated at page 354 of that opinion:

"Depending upon who prevailed, the claims against the debtor's estate would be reduced as to that particular creditor. This cannot be said to affect the administration of the estate."

Accordingly, the existence and use of the proceeds of the letter of credit demonstrates no meaningful difference from the facts in *Yale Express* which would take the instant action from under the controlling impact of the *Yale Express* decision, of the authorities therein cited, and of the reasoning leading to its result.

* The dispute concerning the use and application of the proceeds is a third-party controversy outside the summary jurisdiction of the bankruptcy court for the additional reason that the Eastern trustee, who stands in the shoes of the bankrupt, is estopped as a matter of law from denying that the proceeds of the letter of credit may be applied by Seaboard to its liabilities on Associated as well as Eastern bonds. See *Cissell v. American Home Assurance Co.*, 521 F.2d 790 (6th Cir. 1975), *cert. den.*, 423 U.S. 1074 (1976); *Aldine Trust Co. v. Smith*, 182 F. 449 (3d Cir. 1910). Such application of the proceeds is plainly permitted by the Collateral and Indemnity Agreements (R 359a-367a), to which Eastern was a party, and to which the Eastern trustee makes reference in his own complaint. The trustee has never denied the existence or the terms of those agreements, and thus he has completely failed to raise any fact issue which would preclude the imposition of the estoppel as a matter of law. Therefore the district court erred in deciding that the estoppel question must await the evidentiary hearing on application of the proceeds (R 676a). With the trustee estopped, the dispute concerning the proceeds clearly becomes a third-party controversy.

**C. The proceeds of the letter of credit
do not constitute recourse against
Eastern's trustee.**

The bankruptcy court referred to the proceeds of the letter of credit as a "recourse against Eastern's trustee." In that connection, the affirmed opinion of the bankruptcy court stated:

"If Seaboard had no recourse against Eastern's trustee, the wise teaching of *Yale Express* would properly apply." (R 540a).

We respectfully suggest that the proceeds of the letter of credit do not constitute a "recourse against Eastern's trustee." As has been noted, such collateral had been demanded by Seaboard as a pre-condition to writing its bonds for both Eastern and Associated. Pursuant to the aforementioned Collateral Agreement, Seaboard did indeed have recourse to the proceeds of the letter of credit but such recourse as it had against Eastern's trustee was its right to be subrogated to the rights of setoff possessed by the shippers.

We respectfully urge that none of Seaboard or Eastern or Associated intended that the existence of such proceeds was meant to displace or delay any other rights of recoupment afforded to a surety by law including the right to setoffs concerning which Judge Friendly wrote at 362 F.2d 116:

"Thus, had this been an ordinary bankruptcy, it would have been error to deny the application for setoff."

Clearly, we deal here with "an ordinary bankruptcy."

D. The injunction affirmed below makes it probable that the principal's estate will be inequitably enhanced at the expense of the surety.

The permanent injunction imposed upon Seaboard by the court below bars Seaboard, its officers and its attorneys from notifying any shipper that he has the Section 68a right to set off a cargo claim he may have against a freight bill he may owe the bankrupt.

At the outset, in addressing this injunction, we find it most difficult to understand how a court can properly enjoin a surety or anyone else from informing a shipper of his legal rights. Yet, that is just what the court below has done. Any communication to a shipper, however accurate, is treated as an interference with the trustee's management of the bankrupt's estate and is enjoined.

Such injunction, termed permanent, is clearly meant to continue at least until it has been legally determined that Seaboard has exhausted the proceeds of the letter of credit. At such time, presumably, Seaboard would be permitted, in the process of seeking the benefit of a shipper's setoff, to notify such shipper of the rights given him by Section 68a.

The maintenance of the injunction ignores the fact that during the time that the injunction operates, changes will have taken place which will seriously, and irrevocably, have damaged Seaboard. In this connection, it is again to be remembered that uncontradicted is the statement in the affidavit of Walter S. Wehrell that "Seaboard's liabilities on the bonds and undertakings will far exceed the \$2,000,000 we realized from the letter of credit" (R 358a).

The situation will not have remained in *status quo*. There is no parallel prohibition on the trustee preventing his communicating with the shippers and discouraging

them from utilizing available setoffs. In a similar context, Judge Friendly in *Yale Express* wrote at p. 116:

"The underlying theory that a debt should be discharged 'by the one who in good conscience ought to pay it', Restatement, Security §141 at 384, suggests even more strongly that the principal should not be able to increase the surety's burdens by urging the creditor to proceed against him."

That the trustee here has, in effect, at least, directed the shipper to pursue the surety rather than take the benefit of a setoff, was suggested in his brief below when he wrote that notifying a shipper of his right of setoff would "chill" the collection of the bankrupt's receivables.

The injustice to Seaboard is further highlighted by paragraph 28 of the trustee's complaint which, in pertinent part, reads:

"... that any shipper customer of Eastern who also has a cargo claim against Eastern and who heretofore has paid such freight bill to Eastern, or to the Eastern Trustee, or the Associated Trustee while acting as Receiver of Eastern without asserting or claiming the alleged right of offset, has waived and released such offset and, accordingly, Seaboard in determining the amount owed to such shipper customer is not entitled to such offset." (R 262a).

It is also noteworthy that at paragraph 1(c) of the "Wherefore" clause the trustee demands declaratory judgment to that effect (R 267a).

It need also be stressed that although, as has been noted above, Seaboard's obligations on its bonds exceed the \$2,000,000 proceeds of the letter of credit, there will be no knowledge of Seaboard's ultimate total expenditures

until the passing of as yet unexpired statutes of limitations in the various states in which bonds have been written. With regard to bonds covering Eastern's workmen's compensation obligations, cases now closed can be reopened and Seaboard's payments in other cases may extend for the balance of the lives of the workers injured during the coverage period of such bonds.

Thus, the continuation of the injunction affirmed below and the continued deprivation of Seaboard's use of its right to setoffs inflicts harm upon Seaboard for which no adequate remedy is available and serves to enhance the bankrupt's estate at Seaboard's expense.

POINT III

The trustee's first cause of action should be dismissed for failure to state claims on which relief could be granted.

Neither the bankruptcy court nor the district court reached consideration of the allegations of paragraphs 27 and 29 of the first cause of action and related cross-claims, finding that the existence of the proceeds of the letter of credit disposed of Seaboard's claim to the benefit of setoffs (R 537a, 674a-675a).

Should this Court disagree with the resolution below of the setoff question, as we respectfully urge that it should, then consideration of the other allegations of the first cause of action should lead to its dismissal. Seaboard's position is that assuming all the factual allegations of the complaint as true (not its contentions) the first cause of action need be dismissed as insufficient in law. The Eastern trustee and certain of the co-defendants contend that "because of the prior assignments of the accounts receivable (freight

charges) by Eastern . . . neither the shipper customer nor Eastern, nor Seaboard is entitled to such offsets." (Complaint, para. 27; R 262a).

The fact that Eastern had made assignments of accounts receivable to certain of the co-defendants herein does not affect the applicability of the decision in *Yale Express* to the instant case, even though such assignees may have filed financing statements as provided in Article 9 of the Uniform Commercial Code which deals with secured transactions. Section 9-104 thereof specifically provides:

"This Article does not apply

* * *

(i) to any right of set-off;"

Moreover, clearly controlling on this question is the opinion of the New York Court of Appeals in the case of *Chase Manhattan Bank v. State of New York*, 40 N.Y.2d 590, 388 N.Y.S. 2d 896, 357 N.E.2d 366 (1976). In that case the court clearly defined an issue before it which parallels the one put before this Court by the first cause of action. It stated:

"There are two issues. The first is whether, under the Uniform Commercial Code, a perfected assignment bars a subsequently arising setoff in favor of an account debtor who is without actual notice of the assignment. Restated, the question is whether the constructive notice provided by perfection of a security interest by filing a financing statement under Uniform Commercial Code suffices to preclude an account debtor's right to set off subsequent debts." 40 N.Y.2d at 592.

The Court, through Breitel, Ch. J., directly met this issue stating:

"There must be actual notice of assignment before an assignee may preclude an account debtor's right to set off. Filing with the Secretary of State does not provide actual notice to the State as a debtor." 40 N.Y.2d at 592.

A fortiori, such filing cannot be actual notice to one not the State.

In the instant case, the complaint makes no mention of actual notice to the shippers but relies solely on the filing of the financing statements. Indeed, no actual notice was ever given to any shipper.

At paragraph 29 of the complaint (R 263a), the contention is made on behalf of Eastern and certain co-defendants that a setoff is "... available only to the extent that such freight charges and such cargo claim arise from the same transaction." Such contention is manifestly invalid. As stated in 4 *Collier on Bankruptcy*, Section 68.03, page 854:

"Under the legal and equitable principle of setoff recognized by Section 68a, the mutual debts or credits are generally those arising from *different* transactions." [original emphasis].

This principle is again stated at 4 *Collier on Bankruptcy*, Section 68.04, page 862:

"Under Section 68a it is not necessary that the debts or credits be of the same character. As we have seen, the doctrine of setoff comprehends debts or credits arising from different transactions."

This principle has also been recognized in case law. Thus, in *Chase Manhattan Bank* (*supra*) the New York

Court of Appeals permitted a setoff of unpaid withholding and unemployment insurance taxes by the State against a judgment for engineering services. In *In re Sherman Plastering Corp.*, 346 F.2d 492 (1965), the Court of Appeals of this Circuit permitted in a Chapter XI proceeding the setoff of "an unrelated indemnification claim." In so doing, this Court wrote at 493:

"No legitimate interest would be served by disallowing this set-off, and in fact disallowing the set-off would frustrate the manifest equitable purposes of Section 68. It would put Hanover in the inequitable position of having to pay its debt to Sherman in full while receiving only partial satisfaction of its claim against Sherman. Neither the rehabilitative purposes of a Chapter XI arrangement nor section 68's requirement that the debts be mutual dictates such a result."

Accordingly, the first cause of action fails to state claims on which relief could be granted, and it should therefore be dismissed.

POINT IV

Since the bankruptcy court did not have actual or constructive possession of the proceeds of the letter of credit and since Seaboard did not consent to summary jurisdiction to adjudicate the use and application of the proceeds, the decision below upholding such jurisdiction as a "necessary prerequisite" to the final resolution of the unrelated issues involving setoffs was an improper expansion of summary jurisdiction as limited by the Bankruptcy Act.

The jurisdictional question in this case is whether the bankruptcy court has summary jurisdiction to determine whether Seaboard properly used the proceeds of the \$2,000,000 letter of credit. Should this Court accept our argument, set forth in Points I through III above, that Seaboard's possession of those proceeds as collateral security ought to have absolutely no effect on Seaboard's right to setoffs under *Yale Express*, then no jurisdictional ground remains for any adjudication by the bankruptcy court of whether or not the proceeds were properly exhausted, and there will be no need for this Court to turn to the jurisdictional question presented here. On the other hand, should this Court distinguish *Yale Express* and thus reach the jurisdictional issue, then it also should reverse so much of the decision below as ordered an evidentiary hearing because the bankruptcy court plainly lacks the power to adjudicate the proper use and application of those proceeds.

A. The conclusion below that the bankruptcy court has summary jurisdiction to determine the proper use of the proceeds is not supported by the district court's own analysis and is plainly contrary to settled precedent.

One of the puzzling aspects of the district court's decision is that its analysis of the jurisdictional question should have led to the conclusion opposite to the one actually reached. Most significantly, the district court recognized that Seaboard held possession of the proceeds of the letter of credit as an adverse claimant with a substantial and good faith claim, as established by the uncontroverted affidavit of Walter S. Wehrell, Vice President and Treasurer of Seaboard (R 353a-358a). Therefore, the district court concluded, there is no constructive possession of the proceeds by the bankruptcy court to invest it with summary jurisdiction over them.

Not only did the district court reject constructive possession of the proceeds as a possible foundation for summary jurisdiction, but the district court also expressly rejected the other possible basis of jurisdiction, namely consent by Seaboard (R 671a-672a). In so doing, the district court reversed the very rationale offered by the bankruptcy court for its original assertion of jurisdiction over the proceeds.

The bankruptcy judge, in his opinion, had declared that "by proceeding on the merits of the asserted right to set-offs, an issue inextricably intertwined with the existence of the proceeds of the letter of credit, Seaboard has consented to the court's jurisdiction" (R 538a). The district judge, to the contrary, held that any recognition by Seaboard of summary jurisdiction over setoffs was "immaterial" (R 671a), and that "... jurisdiction over the proceeds question cannot properly be predicated upon an alleged consent by Seaboard to jurisdiction over the re-

lated issue of setoffs" (R 672a). Inexplicably, the district court, while repudiating the reasoning of the bankruptcy court below, did not also overturn the plainly erroneous conclusion which the bankruptcy court had derived from that reasoning.

Having eliminated both constructive possession and implied consent as bases for summary jurisdiction, the district court then proceeded to close off the last remaining possible basis by refusing to rest jurisdiction over the proceeds upon an alleged express consent by Seaboard (R 671a).

In sum, the district court reviewed and rejected all the rationales that had been advanced below to sustain the assertion of summary jurisdiction over the proceeds, only to shrink back from drawing the correct conclusion that Seaboard's motion to dismiss for lack of jurisdiction over those proceeds should be granted. Instead the district court concluded that it would affirm the bankruptcy court even in the absence of "an independent basis" for jurisdiction:

"... it is not necessary to resolve the arguments asserting and denying the existence of an independent basis for jurisdiction to sustain the Bankruptcy Judge's decision to determine the proper use and application of the proceeds of the letter of credit. This is so because, in light of my agreement with the substantive decision, that determination is a necessary prerequisite to the final resolution of the rights of the parties with respect to the setoffs, over which the court clearly has jurisdiction." (R 672a-673a).

The first thing to be said about this rationale of the district court is that it simply ignores the well-established rule that where, as here, the disputed assets are

possessed by a third party who makes a substantial claim to them, the bankruptcy court is without jurisdiction, and the trustee must resort to a plenary action. The case of *Jaquith v. Rowley*, 188 U.S. 620 (1903), concerned, as does this case, a trustee's challenge to the right of a surety to hold money placed with it as security to indemnify it on bonds issued on behalf of the bankrupt. The Supreme Court there held that the trustee could not avail himself of the summary procedure and would have to assert his claim in a plenary action:

"The surety claims the right to hold money as against everybody until his liability on the bail bond is satisfied, and that claim is adverse to any claim that the trustee may make upon him for the money which is to indemnify him as stated . . .

"If the trustee has the right to obtain possession of the money from the surety, he must assert it in accordance with the provisions of section 23 of the bankruptcy act and not by this summary proceeding in bankruptcy." 188 U.S. at 625-26.

Similarly, the First Circuit Court of Appeals held in *In re Horgan*, 158 F. 774 (1907), that a plenary action was necessary to test the asserted right of the sureties to hold money deposited with them until their liability upon the bonds which had been issued was determined and satisfied.* See 1 Collier, *Bankruptcy Manual* ¶ 23.04[1], and 5 *Remington on Bankruptcy* § 2161.

* Seaboard's position below was that, in light of the bankruptcy court's lack of jurisdiction over the proceeds, the third cause of action should be dismissed outright, rather than transferred to the civil docket of the district court pursuant to Bankruptcy Rule 915(b), because no independent ground for federal jurisdiction was present.

(Footnote continued on following page)

Clearly the determination of the surety's right to hold the collateral placed with it as security was just as much a "necessary prerequisite" to the "final resolution of the rights of the parties" involved in *Jaquith* and *In re Horgan* as it is here, but that certainly did not deprive each of the sureties in those cases of his right to a plenary action. In short, this is not a case without precedent, but a case where the district court failed to follow settled authority. The district court cited no statutory or case authority to support its jurisdictional holding and did not attempt to explain why the well-reasoned precedents of *Jaquith* and *In re Horgan* did not control, as they should have, its decision on jurisdiction.

The next thing to note is that the reason why the bankruptcy court had ordered an evidentiary hearing adjudicating whether Seaboard had properly used the proceeds was plainly not because a decision on that issue is, in the district court's characterization, a "necessary prerequisite" to a final resolution of the setoff issues. On the contrary, this present appeal is an appeal from a final order of the bankruptcy court entered in the trustee's favor on the setoff issues. The bankruptcy court's order unequivocally granted the trustee declaratory "relief" (which we interpreted to mean declaratory judgment) with respect to paragraphs 24, 25 and 26 of the *first* cause of

(Footnote continued from preceding page)

13 Wright, Miller & Cooper, *Federal Practice and Procedure* § 3570; 1 Collier, *Bankruptcy Manual* ¶ 23.01. There was no diversity jurisdiction since both Seaboard and Eastern are New York corporations, as are Manufacturers and, for diversity purposes, Chase. See 28 U.S.C.A. § 1348. Certainly the claim to the proceeds of the letter of credit did not appear to involve any federal question, and federal question jurisdiction was not conferred merely because a trustee in bankruptcy was the plaintiff. *Newland v. Edgar*, 362 F.2d 911 (9th Cir. 1966).

action of the complaint* "to the extent that no setoff can be claimed by Seaboard until the proceeds . . . are exhausted, *as ultimately found by a court of competent jurisdiction.*" (Emphasis added; R 547a).

By its order the bankruptcy court disposed of the set-off issues in this lawsuit without even purporting to resolve the question of whether Seaboard had made proper use of the proceeds, thus demonstrating that the determination of the latter question was hardly a "necessary prerequisite" to the determination of the former. Therefore, when the bankruptcy court proceeded to set the matter down for an evidentiary hearing, it was saying that it was a "court of competent jurisdiction" empowered by the Bankruptcy Act to determine whether the proceeds in Seaboard's possession were held by Seaboard as collateral security only on bonds expressly issued in the name of Eastern or on bonds issued in the name of Associated as well as Eastern, an issue squarely raised by

* While in its opinion the bankruptcy court seized upon the legal theory advanced by the trustee in paragraph 48 of the third cause of action (R 266a), its order actually (i) denied Seaboard's motion for declaratory relief sustaining its position as described in paragraphs 24, 25 and 26 of the first cause of action, and (ii) granted the trustee declaratory judgment with respect to Seaboard's contentions as set forth in those paragraphs, which provide:

"24. Upon information and belief, Seaboard contends that Eastern has a right to set off against any cargo claims against Eastern the amount of freight charges owed by any such claimant to Eastern.

"25. Upon information and belief, Seaboard contends that a shipper owing freight charges to Eastern has a right to set off against such freight charges the amount of any cargo claim owed to such shipper by Eastern.

"26. Upon information and belief, Seaboard further contends that in determining the amount it owes to a shipper because of its obligations under the bonds it has issued to Eastern, Seaboard is entitled to such offsets." (R 262a).

the *third* cause of action and by the related cross-claims of Chase, Manufacturers, and the other third parties.

It is true, of course, that the district court, after holding that the bankruptcy judge had properly assumed jurisdiction to determine whether Seaboard had properly used the proceeds, went on to say:

"Whether, after such hearing, the Bankruptcy Court would have jurisdiction to compel any particular use of the physical proceeds or issue any other orders which cannot directly be predicated on his jurisdiction over the setoff issue is another question. Because it is not yet clear just what additional matters the Bankruptcy Judge intends to reach in this case, and because some of the parties, including the Eastern trustee, have taken positions in their briefs apparently disclaiming any assertion of jurisdiction over the proceeds themselves¹ these questions must abide the further course of this litigation."

¹ The Eastern trustee states that it is not alleging 'jurisdiction over the proceeds of the letter of credit and [asking the court to] cause their use or disposition.' International Harvester asserts that 'it is not necessary that Seaboard be commanded to make any particular disposition of the Letter of Credit proceeds.'" (R 673a-674a).

It is, however, no answer to Seaboard's objection to summary jurisdiction for the district court to leave the questions concerning the precise reach of the bankruptcy court's jurisdiction to "abide the further course of this litigation." (R 674a). An objection to the court's power to hold a trial is not satisfied by holding the trial. Moreover, the principles of res judicata and collateral estoppel clearly apply in bankruptcy, *see, e.g., Chicot County Drainage District v. Baxter State Bank*, 308 U.S. 371

(1940), and the district court's purported reservation may well be illusory.

Certainly it is of little solace for Seaboard to be told that although the bankruptcy court may lack jurisdiction to "compel any particular use of the physical proceeds," it nevertheless has power to hold an evidentiary hearing (with collateral estoppel effects) to determine "the availability" to Seaboard of the proceeds in a "legal" sense (R 673a-674a). Thus, although the district court's decision purports to keep certain aspects of the jurisdictional dispute open for future, or possibly even plenary resolution, it actually compels Seaboard to litigate in the evidentiary hearing those very issues concerning the proper use of the proceeds with regard to which the bankruptcy court itself lacks summary jurisdiction. The result expands the summary jurisdiction of the bankruptcy court so far beyond the limits of the Bankruptcy Act that for all practical purposes Seaboard's right to a plenary action would be completely preempted by the adjudication of the bankruptcy court.

B. The need for full administration of a bankrupt's estate does not here justify the assertion of summary jurisdiction.

The effect of the affirmed order of the bankruptcy court is to compel Seaboard to litigate the use and application of the proceeds in summary bankruptcy proceedings simply because it has been deemed necessary to resolve the issue before the bankrupt's estate can be fully administered. In one stroke the decision below obliterates the carefully-defined boundary separating summary from plenary jurisdiction. If all issues related to the administration of a bankrupt's estate were adjudicable in summary proceedings just because they had to be determined

in the course of administering a bankrupt estate, then no plenary action would ever be required.

The law, however, is that under the Bankruptcy Act the grant of summary jurisdiction to the bankruptcy court is limited to situations, unlike this case, where either possession or consent is present to justify summary proceedings. It is possible, of course, for Congress to vary this statutory scheme, and even now Congress has before it a new bankruptcy statute which would vastly expand the bankruptcy court's jurisdiction. See *New York Law Journal*, Tuesday, December 27, 1977, page 1, col. 2. But the point is that Congress has not so acted, and under the law presently in effect, the adverse claimant is protected against a summary suit by a trustee claiming property in the possession of the adverse claimant. See *Taubel-Scott-Kitzmiller Co. v. Fox*, 264 U.S. 426, 430-31 (1924).

Under the Bankruptcy Act as applied and interpreted by the courts, the test for whether or not summary jurisdiction extends to a given issue is not whether the issue must be resolved in the course of administering the bankrupt estate. Rather, the test is whether the issue as to which summary jurisdiction is disputed arises from the same transaction as an issue as to which summary jurisdiction concededly exists. *Daniel v. Guaranty Trust Co. of New York*, 285 U.S. 154 (1932); *In re Majestic Radio and Television Corp.*, 227 F.2d 152 (7th Cir. 1955), cert. den., 350 U.S. 995 (1956); *Tamasha Town and Country Club v. McAlester Construction Finance Corp.*, 252 F. Supp. 80 (S.D. Cal. 1966). Here, the same transaction test, not discussed by the district court, should have been applied to deny summary jurisdiction over the proceeds, since plainly the issues as to setoffs and the use of the

proceeds spring from different and unrelated transactions.*

While there are cases, including *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964), holding that a bankruptcy court has inherent jurisdiction to resolve all disputes necessary to complete administration of an estate, that line of cases has been confined in this Circuit by this

* The setoffs arose out of numerous separate transactions between Eastern and the various shippers and from a number of separate events connected with those shipments (giving rise to workmen's compensation claims; bodily injury and property damage claims and suits; claims for loss of, or damage to, cargo, etc.). Those transactions are entirely separate and distinct from the transaction, described in the Wehrell moving affidavit (R 353a-358a), pursuant to which Seaboard agreed to undertake suretyship for both Eastern and Associated upon being furnished with the Chase letter of credit as collateral. The amount of each of the setoffs will turn on an evaluation of the amount and nature of each individual claim by each shipper and the amount of each receivable owed to Eastern. On the other hand, Seaboard's right to have used the proceeds of the letter of credit will be determined by the governing agreements, particularly the Collateral and Indemnity Agreements (R 359a-367a).

It follows that neither of the two cases cited by the bankruptcy court support the holding below since in each of those cases the summary jurisdiction upheld applied only to issues integral to a single transaction, *i.e.*, arising from a single agreement between identical parties. In *James Talcott, Inc. v. Glavin*, 104 F.2d 851 (3d Cir. 1939), *cert. den.*, 308 U.S. 598 (1939), Talcott's claims and the trustee's counterclaims were merely reverse sides of the same coin, and a decision on one automatically resolved the other. In *In re Dolly Madison Industries, Inc.*, 326 F. Supp. 441 (E.D. Pa. 1971), the rescission of the contracts and the return of the stock both turned on the identical issue of whether the arrangement had been fraudulently induced; in addition, both the claimant and the trustee there had expressly consented to summary jurisdiction. Further, in both *Talcott* and *Dolly Madison*, the claimant himself had initiated the summary proceeding, whereas here Seaboard was a defendant compelled to respond to the trustee's summons and notice of trial.

Court to reorganization and arrangement cases, where due to unusual circumstances the reorganization or arrangement cannot proceed.* *Law Research Service, Inc. v. Crook*, 524 F.2d 301 at 314 (2d Cir. 1975). Were the position taken here by the district court to prevail, the exception would have swallowed the statutory rule distinguishing summary from plenary proceedings. This is so because, as noted above, in any bankruptcy proceeding, all disputes between third parties or involving different transactions need to be resolved before the estate can be finally wound up, and if all such disputes were susceptible of summary treatment, as a "necessary prerequisite" for the final resolution of the bankruptcy, then no scope would remain for the plenary action.

Just as the need to resolve a given issue in the course of complete administration of a bankrupt estate does not confer jurisdiction over that issue upon the bankruptcy court, so the nature of the issue itself may bear upon the jurisdictional decision. Here, litigation as to the proper use of the proceeds will turn upon the application of state substantive law concerning suretyship, construction of contracts, estoppel, and similar issues, rather than upon federal bankruptcy law. Where such non-bankruptcy questions will predominate, plenary proceedings should be preferred over summary proceedings in bankruptcy. *Thompson v. Magnolia Co.*, 309 U.S. 478 (1940); *In re*

* The *O'Dell* case, in addition to having been limited by this Court in *Law Research*, was also limited by the Tenth Circuit itself in *First State Bank and Trust Company of Guthrie, Oklahoma v. Sand Springs State Bank*, 528 F.2d 350 (10th Cir. 1976), where the court held that the rationale of *O'Dell* did not apply even in a reorganization case when the administration of the estate could proceed without resolution of the third-party dispute. Here, in a straight bankruptcy, the trustee similarly has no administrative interest in the question of the use of the proceeds, and the resulting third-party dispute falls outside summary jurisdiction in bankruptcy.

Wonderbowl, Inc., 456 F.2d 954 (9th Cir. 1972); *In re Herz Importing Corp.*, 349 F. Supp. 1106 (S.D.N.Y. 1972).

Again, although perhaps more evident in a reorganization proceeding than in a straight bankruptcy such as this one, plenary adjudication of the use of the proceeds should be preferred where, as here, there is some question of the *appearance* of institutional bias in the bankruptcy court. This Court took note of this very real factor in its decision by Judge Friendly ordering a plenary action instead of a summary proceeding in *In re Lehigh and Hudson River Railway Company*, 468 F.2d 430, 434 (1972):

"A substantial contention that the setoff had been made before it was enjoined should therefore be passed upon in a plenary action, preferably before a judge not subject to the *appearance*—and we know here it is nothing more than that—of possible partiality inevitably attaching to the court burdened with the arduous task of keeping the debtor alive while the possibility of rehabilitation is being explored."

Some of the forthright statements made by the bankruptcy judge here would certainly appear to reflect his strongly-held view that his entire task is to marshal the assets of the bankrupt as requested by the trustee, even if it should be at the expense of a third-party adverse claimant like Seaboard. The bankruptcy judge himself recognized the distinction we here urge when he acknowledged that he is "not a Court of plenary jurisdiction that comes to this dispute free as the driven snow" and when he emphasized that he is "not starting on a clean slate, I am starting with a head start." (R 150a).

Just as this Court acknowledged in *In re Lehigh and Hudson River Railway Company*, 468 F.2d 430, 434 (1972), the avoidance of any appearance of institutional bias is a desirable goal and one which here provides yet another valid reason for requiring a plenary, rather than summary, trial of the issue of the proper application of the proceeds.

C. Interests of judicial economy cannot override the limits placed by the Bankruptcy Act on summary jurisdiction.

Underlying the district court's jurisdictional decision is plainly the tacit rationale that the interests of judicial efficiency and economy justify the court's otherwise unwarranted extension of summary jurisdiction in bankruptcy. This argument has been frequently urged upon, but consistently rejected by, the courts. As the Supreme Court stated in *Galbraith v. Vallely*, 256 U.S. 46, 50 (1921):

"It may be, as suggested by the Circuit Court of Appeals, that a summary proceeding at the instance of the trustee would afford a more speedy and economical administration of the estate in bankruptcy. But the right to recover in such instances, only in suits of the ordinary character, with the rights and remedies incident thereto, has been consistently maintained by this court."

Of course, the trustee and the bankruptcy judge might well prefer, as they do here, to see a matter litigated in summary proceedings. But as Judge Weinfeld pointed out in *Tenenbaum v. Walter E. Heller & Company*, 308 F. Supp. 1085 (S.D.N.Y. 1970), Congress enacted the jurisdictional limitations of Section 23 of the Bankruptcy Act, 11 U.S.C.A. § 46, in order to protect the adverse

claimant, not the trustee, from inconvenience and hardship.*

Given the well-recognized differences in procedure and, as noted above, in apparent institutional bias between summary proceedings in the bankruptcy court and the ordinary procedures of a plenary action, it comes as no surprise that Seaboard should insist on its right to plenary adjudication of the application of the proceeds. There are differences in discovery and appellate procedures. These factors are of consequence to Seaboard, and alleged interests of judicial economy should not be permitted to deprive Seaboard of the plenary suit to which it is entitled as an adverse claimant with possession of the proceeds.

This Court, in *In re Investors Funding Corp. of New York*, 547 F.2d 13, at 17 (1976), expressly disapproved the notion that considerations of judicial convenience can subject an adverse claimant with possession, such as Seaboard here, to summary proceedings:

"Judge Bonsal understandably hoped to save all the parties the expense of an additional action by cutting through legal 'rights' to reach what would seem to the casual observer a very equitable and practical solution to the controversy, but he simply lacked the power to do so here."

We come back then to the fundamental truth of *Daniel v. Guaranty Trust Co. of New York*, 285 U.S. 154, 162 (1932), that the demand for the speedy administration of bankrupt estates is not enough "to justify such a radical departure from ordinary procedure." The district

* Arguably judicial economy will be best served here by the dismissal of the summary proceeding for lack of jurisdiction because it may well be that no plenary suit will ever be brought.

court erred in refusing to order the dismissal for lack of jurisdiction of those paragraphs of the third cause of action, and the related cross-claims, which seek an adjudication of the proper use and application of the proceeds of the letter of credit, and therefore the decision below should be reversed.

CONCLUSION

The orders of the district court and the bankruptcy court should be reversed insofar as they (1) granted to the Eastern trustee declaratory judgment that Seaboard could not avail itself of the benefit of setoffs until the proceeds of the letter of credit had been exhausted, on the ground that the existence of the proceeds distinguished this Court's decision in *Yale Express*; (2) made permanent an injunction against interference by Seaboard with the assets and property of the Eastern estate; (3) denied Seaboard's motion to dismiss the first cause of action of the complaint, and related cross-claims, on the ground of failure to state claims on which relief could be granted; and (4) denied Seaboard's motion to dismiss for lack of summary jurisdiction so much of the third cause of action of the complaint, and related cross-claims, as sought

adjudication of the use and application of the proceeds
of the letter of credit.

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Respectfully submitted,

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